You're Moving to a Prototype? Say It Isn't So

8/12/2010
Heidi A. Lyon

Here is a statement benefits attorneys dread hearing from a client: "We're moving to a prototype retirement plan document." Why?

It's not because these documents generate less work for us. In fact, these documents tend to generate a significant amount of work for us. Those words make us uncomfortable because our retirement plan clients so often have negative experiences using these documents.

For those unfamiliar with prototype retirement plan documents, they are cookie-cutter documents, often drafted by an investment services provider, which specify the legal terms of a tax-qualified retirement plan. The drafter makes the choices about the design of the document and any employer adopting the document must adhere to them.

When prototype plans are used with proper legal oversight, they may be adequate for simple plans. But, often they are unable to accommodate more complex plans because legal limits apply to the changes that can be made to them. These documents also present increased compliance risks that don't arise with documents drafted by a plan's attorney, such as volume submitter or individually-designed retirement plans. In addition, their design features tend to depend on what's most administratively convenient for the drafter. Since the attorney for a plan doesn't handle the plan's daily administration, there is no similar motivation for the attorney to limit the plan's design options.

The Problems

Here are some examples of the difficulties an employer may face in using a cookie-cutter document:

- Employer A is a small business whose bank puts it onto a prototype document to save money. The salesperson tells Employer A to call him to make any changes. Employer A does this for several years and doesn't think twice about the actual document because the bank handles it. Or, that's what Employer A thought. When Employer A's owner retires and sells the company, the purchaser asks to review Employer A's plan document. Employer A discovers the document contains an impermissible combination of design options. In addition, every change Employer A had requested was written into the margin of the document. No written amendment exists. The sale of Employer A's company is held up by two months, Employer A must deposit $75,000 into escrow before the sale will close to cover any potential losses from the failure, and must spend $25,000 to file the plan with the IRS for correction.

- Employer B decides to move its plan to Trust Company X. Months later, after Employer B has educated employees about the move, it learns it must use Trust Company X's new plan document, requiring Employer B to change much of it's plan design. For example, Employer B has counted hours of service for vesting because it has a substantial number of part-time participants who work less than 1,000 hours per year and leave the company before becoming fully vested. Trust Company X's plan document requires the use of the elapsed time method where an employee doesn't have to work a minimum number of hours to get vesting service credit. Employer B must change its plan design and credit all part-time participants with vesting service, reducing the likelihood it can recover contributions from those participants when they leave. Employer B also discovers Trust Company X won't hold certain assets, like life insurance or CDs that are already in the plan. It must create a second trust to hold those assets. It's too late for Employer B to undo its decision to move, so now it must act as trustee for the separate trust and have legal counsel check every amendment Trust Company X adopts to ensure the separate trust remains compliant. Employer B may be getting the investments it wants, but no longer has the plan design it wants and hasn't saved any money.

- Employer C maintains an employee stock ownership plan and Employer C's third-party administrator offers to put the plan on a prototype plan document. The problem with that.: The IRS does not permit employee stock ownership plans to be prototype plans. Now Employer C has a tax qualification failure and, in addition to obtaining a new document, must incur the expense of penalties.

In each example, the document had a disclaimer that the drafter wasn't liable for any compliance failures and the employer should review it with counsel. But all the employer was told was that the IRS had pre-approved the document and that review by counsel was unnecessary. In reality, what the IRS approved was a series of provisions that could only be used together in a particular way. Otherwise, the pre-approval was meaningless.

Think of it this way: Just because companies use the same IRS form to prepare their income taxes doesn't mean they can enter the same information on that form and enjoy every combination of tax breaks. Each taxpayer's individual circumstances matter . . . a lot. Plans work the same way.

Employers can end up spending a lot more on government sanctions and legal fees to fix compliance issues than if they had adopted a customized document or worked with an attorney at the beginning of the process. This raises the question of whether using a prototype plan can save money. Warner Partner Vern Saper has authored a more detailed article on this subject that we provide to clients upon request.

Suggestions For Moving Forward

Despite the risks, some employers may conclude a prototype plan works best for them. If you are considering a document change, here is some advice:

- Move the plan on your own timeline. Don't commit yourself to moving your plan until you've seen the prototype document and had it reviewed by your attorney, so you know exactly what will have to change.

- Review the new plan with your attorney. Your investment services provider or third-party administrator usually will not (and generally is not legally permitted to) give you legal advice. The sooner you get your attorney involved, the more likely you are to reduce future expenses and administrative hassles.

- Don't buy into the myth that a prototype plan will take care of itself. You should ask questions and ensure that it always reflects the way in which you are operating the plan. If you want to amend the plan, consult your attorney to ensure you're not losing your reliance on the pre-approved document. Also, notify the service provider of your intent as soon as possible. Some of the largest service providers need months to get approval of an amendment before they implement it.

- Consider submitting your new plan document to the IRS for a determination letter. This provides you with additional security that your plan is qualified, can help you catch errors before the IRS does and makes getting a future determination letter much easier.

- If you have a diverse group of employees or locations, offer unusual investment options, make frequent plan design changes or experiment with features that are not commonly used and easy to administer (e.g., cross-testing, life insurance, mortgage loans, real estate investments or employer stock), a prototype plan probably isn't right for you.

Following this advice can save you time and money. And while we usually recommend against adopting a prototype plan, it is far less troublesome for a client to adopt one when we have had the opportunity to ensure that the client's needs are being met

So if you're examining your document options, please contact a member of our Employee Benefits Group. We want the best result for you and won't dread hearing about your document decision if we're sure you're getting the best.